Office - Supreme Court, U.S.
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ALEXANDER L. STEVAS,
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No. 82-1244

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CITYTRUST AND CITYTRUST BANCORP, INC.,
Petitioners,

v.

ATHALIE DORIS JOY,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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January 24, 1983

TABLE OF CONTENTS

Page

Table of Cases and Authorities.....ii

Summary of Argument.....2

Introduction—Issue of State Law.....2

Court of Appeals Applied Connecticut Law.....3

Court of Appeals not Required to Defer to District Court's View of Connecticut Law.....7

No Conflict with *Burks*.....9

No Conflict Between Circuits.....10

Purported Due Process Issue.....11

Conclusion.....13

APPENDIX:

APPENDIX A:
Plaintiff-Appellant's Brief to U.S. Court of Appeals (pp. 19-24).....1a

APPENDIX B:
Plaintiff-Appellant's Reply Brief to U.S. Court of Appeals (pp. 1-4).....7a

TABLE OF CASES AND AUTHORITIES

Page

CASES

Abbey v. Control Data Corp., 603 F. 2d 724 (8th Cir. 1979), *cert. den.* 444 U.S. 1017 (1980).....11

Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S. 2d 920, 393 N.E.2d 994 (1979).....6

Bernhardt v. Polygraphic Co., 350 U.S. 198 (1956).....7

Burks v. Lasker, 441 U.S. 471 (1979).....2,3,7,9,10

Butner v. U.S., 440 U.S. 48 (1979).....7

Clark v. Lomas & Nettleton Financial Corp., 625 F.2d 49 (5th Cir. 1980), *cert. den.* 450 U.S. 1029 (1981).....11

Erie Railroad Co. v. Tompkins, 304 U.S. 64 (1938).....7,8

Ferris v. Polycast Technology Corp., 180 Conn. 199, 429 A.2d 850 (1980).....4,5,6

Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. den.* 102 S. Ct. 1006 (1982).....10

Huss v. Prudential Ins. Co. of America, 37 F. Supp. 364 (D. Conn. 1941).....8

Kloput v. Northrup, 131 Conn. 14, 39 A.2d 700 (1944).....5

Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. den.* 449 U.S. 869 (1980).....10

Mallory v. Mallory Wheeler Co., 61 Conn. 131, 23 A. 708 (1891).....5

Massoth v. Central Bus Corporation, 104 Conn. 683, 134 A. 236 (1926).....5

Osborne v. Locke Steel Chain Co., 153 Conn. 517, 218 A.2d 526 (1966).....5

Pearlman v. Feldman, 219 F.2d 173 (2nd Cir. 1955).....5

Sisk v. Jordan Co., 94 Conn. 384, 109 A. 181 (1920).....5

Town of East Troy v. Soo Line Railroad Company, 653 F.2d 1123 (7th Cir. 1980).....8

Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. Sup. Ct. 1981).....11,12

STATUTES

Conn. Gen. Stat. '33-320 (Rev. of 1958 as amended).....6

Conn. Gen. Stat. '33-323 (Rev. of 1958 as amended).....6,7

Conn. Gen. Stat. '52-572j (Rev. of 1958 as amended).....6

RULES

Federal Rules of Civil Procedure 56.....12

Supreme Court Rule 17.....7

Supreme Court Rule 19.....7

OTHER AUTHORITIES

Lattin, *Corporations* (1971).....4

1A (Pt. 2) Moore, Federal Practice ,0.309[2]
(2nd ed. 1982).....8

Note, *Justice Frankfurter—The Erie Doctrine,*
67 Yale L.J. 187 (1957).....7

QUESTIONS PRESENTED

1. Whether the Second Circuit, contrary to the principles announced by this Court in *Burks v. Lasker* and in conflict with the decisions of other courts of appeals, properly established a rule requiring the federal court to exercise its business judgment, in disregard of the judgment of independent directors, as to the best interests of a corporation in continuing a shareholder's derivative suit.

2. Whether the Second Circuit deprived the petitioners of due process of law in violation of the Fifth Amendment to the United States Constitution by exercising its own business judgment without first allowing the petitioners the opportunity to present evidence on the issue in the District Court.

PARTIES TO THE PROCEEDINGS

Petitioners Citytrust and Citytrust Bancorp, Inc.* were defendants and appellees below, and respondent was the plaintiff and appellant below. In addition to the petitioners, the defendants were: Nelson L. North, Robert C. Baldwin, Herman K. Beach, Jr., Edward M. Bleser, Philip H. Burdett, Cameron Clark, Jr., Walter M. Goddard, Richard F. Gretsch, Harlan H. Griswold, William A. Haist, Jr., Edward E. Harrison, William C. Keator, Charles T. Kellogg, Dr. Henry W. Littlefield, Hubert T. Mandeville, P. Douglas Martin, Horace Merwin, Frederick R. Miller, William R. Moody, Hoyt O. Perry, Jr., E. Cortright Phillips, William E. Roberts, Philip H. Sagarin, Norman Schaff, Jr., Charles E. Spencer, III, Reid C. Spencer, Harold P. Splain, Francis W. Stosse, Daniel F. Wheeler and Robert H. Whitney. It is anticipated that some of the above defendants will file a separate petition for a writ of certiorari in this Court.

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*Petitioners do not have any other parent companies, subsidiaries (except wholly owned subsidiaries) or affiliates.

TABLE OF CONTENTS

	Page
Opinions below	2
Jurisdiction	2
Statutes and Constitutional Provisions Involved	2
Statement of the Case	2
Reasons for Granting the Petition	5
Introduction	5
I. This Court Should Grant the Petition to Restrict Federal Court Interference with the Bona Fide Business Judgment of Corporate Directors	6
A. The Second Circuit's Decision Is Contrary to the Instruction of *Burks v. Lasker*	6
B. The Second Circuit's Decision Conflicts with the Decisions of Other Courts of Appeals and Demonstrates the Need to Revisit the Rule of *Burks v. Lasker*	8
II. This Court Should Grant the Petition Because the Second Circuit Deprived Petitioners of Due Process of Law	13
Conclusion	15
Appendix	
A. Opinion of the Court of Appeals for the Second Circuit	A-1
B. Opinion of the District Court for the District of Connecticut	B-1
C. Order Denying Petitions for Rehearing with Suggestion for Rehearing in Banc	C-1
D. Connecticut Statutes	D-1

TABLE OF AUTHORITIES

Page

Abbey v. Control Data Corp.,
603 F.2d 724 (8th Cir. 1979), *cert. denied*,
444 U.S. 1017 (1980) 9, 11

Abella v. Universal Leaf Tobacco Co.,
495 F. Supp. 713 (1980), *modified*, 546 F. Supp.
795 (E.D. Va. 1982) 9

Auerbach v. Bennett,
47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d
920 (1979) 9, 10

Bernhardt v. Polygraphic Co. of America,
350 U.S. 198 (1956) 9

Bowen v. United States,
570 F.2d 1311 (7th Cir. 1978)..... 9

Burks v. Lasker,
441 U.S. 471 (1979) ..... *passim*

Clark v. Lomas & Nettleton Financial Corp.,
625 F.2d 49 (5th Cir. 1980), *cert. denied*,
450 U.S. 1029 (1981) 9, 11

Gaines v. Haughton,
645 F.2d 761 (9th Cir. 1981), *cert. denied*,
102 S. Ct. 1006 (1982)..... 9, 11

Gall v. Exxon Corp.,
418 F. Supp. 508 (S.D.N.Y. 1976)..... 9

Genzer v. Cunningham,
498 F. Supp. 682 (E.D. Mich. 1980)..... 9

Grossman v. Johnson,
89 F.R.D. 656 (D. Mass. 1981), *aff'd on other*
grounds, 674 F.2d 115 (1st Cir. 1982) 9

Hamling v. United States,
418 U.S. 87 (1974) 14

Hasan v. CleveTrust Realty Investors,
548 F. Supp. 1146 (N.D. Ohio 1982) 9

Helis v. Ward,
308 U.S. 365 (1940) 14

Hensley v. E. R. Carpenter Co.,
633 F.2d 1106 (5th Cir. 1980)..... 8

Joy v. North,
692 F.2d 880 (2d Cir. 1982) ..... *passim*

Joy v. North,
519 F. Supp. 1312 (D. Conn. 1981), *rev'd,*
692 F.2d 880 (2d Cir. 1982) 2, 4, 9, 12, 13

Lasker v. Burks,
567 F.2d 1208 (2d Cir. 1978), *rev'd,* 441 U.S.
471 (1979) 6

Lewis v. Anderson,
615 F.2d 778 (9th Cir. 1979), *cert. denied,*
449 U.S. 869 (1980) 9, 11

Lomartira v. American Automobile Insurance Co.,
371 F.2d 550 (2d Cir. 1967) 9

Mills v. Esmark, Inc.,
544 F. Supp. 1275 (N.D. Ill. 1982) 9

Public Affairs Associates, Inc. v. Rickover,
369 U.S. 111 (1962) 13

Roberts v. Alabama Power Co.,
404 So.2d 629 (Ala. 1981)..... 9, 10

Rosengarten v. International Tel. & Tel. Corp.,
466 F. Supp. 817 (S.D.N.Y. 1979)..... 9

Saunders v. Shaw,
244 U.S. 317 (1917) 13, 14

Siegal v. Merrick,
84 F.R.D. 106 (S.D.N.Y. 1979)..... 9

Stein v. Bailey,
531 F. Supp. 684 (S.D.N.Y. 1982) 9

United Copper Securities Co. v. Amalgamated Copper Co.,
244 U.S. 261 (1917) 6, 10

Watts v. Des Moines Register and Tribune,
525 F. Supp. 1311 (S.D. Iowa 1981) 9

Zapata Corp. v. Maldonado,
430 A.2d 779 (Del. Sup. Ct. 1981) 9, 10

FEDERAL STATUTES

12 U.S.C. § 21 *et seq.* 3
28 U.S.C. § 1254(1) 2
28 U.S.C. § 1331 3
28 U.S.C. § 1332(a)(1) 3

STATE STATUTES

Conn. Gen. Stat. Ann. § 33-313(a) (West 1982) ... 2, 12
Conn. Gen. Stat. Ann. § 33-318(a) (West 1982) ... 2, 12
Conn. Gen. Stat. Ann. § 33-320a(b) (West 1982) ... 2, 8
Conn. Gen. Stat. Ann. § 33-323 (West 1982) 2, 8
Conn. Gen. Stat. Ann. § 52-572j (West 1982) 2, 8

OTHER AUTHORITIES

UNITED STATES CONSTITUTION, FIFTH AMENDMENT .. 2
MODEL BUSINESS CORPORATION ACT §§ 35 and 42 (1977 Supp.) 12

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners Citytrust and Citytrust Bancorp, Inc. respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding.

OPINIONS BELOW

The opinion of the Court of Appeals for the Second Circuit, entitled *Joy v. North, et al.* (App. A, *infra*, A-1 to A-42), is reported at 692 F.2d 880 (2d Cir. 1982). The opinion of the District Court for the District of Connecticut (App. B, *infra*, B-1 to B-30) appears at 519 F. Supp. 1312 (D. Conn. 1981).

JURISDICTION

The judgment of the Court of Appeals was entered on November 4, 1982. A timely petition for rehearing with suggestion for rehearing in banc was denied on December 21, 1982, and this petition for certiorari was filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND CONSTITUTIONAL PROVISIONS INVOLVED

Fifth Amendment, United States Constitution:

No person shall . . . be deprived of life, liberty, or property, without due process of law . . . .

Statutes

The Connecticut statutes cited herein, Conn. Gen. Stat. Ann. §§ 33-313(a), 33-318(a), 33-320a(b), 33-323 and 52-572j (West 1982), are reprinted in Appendix D.

STATEMENT OF THE CASE

Respondent Athalie Doris Joy instituted this shareholder's derivative suit in the District of Connecticut on behalf of Citytrust and Citytrust Bancorp, Inc. (collectively, the "Corporations") against numerous officers and directors of the Corporations. The complaint alleged violations of the National Bank Act, 12 U.S.C. § 21 *et seq.*, and breaches of common law fiduciary duties, all arising out of a series of

loans extended by Citytrust. Jurisdiction was premised upon both a federal question, 28 U.S.C. § 1331, and diversity of citizenship, 28 U.S.C. § 1332(a)(1).

Shortly after this Court's decision in *Burks v. Lasker*, 441 U.S. 471 (1979), the boards of directors of the Corporations authorized the establishment of a special litigation committee (the "Committee") composed of two disinterested, non-defendant directors. The board of directors delegated to the Committee the power to review, investigate and analyze the circumstances surrounding the derivative suit, and to determine whether the continued prosecution of the action was in the best interests of the Corporations.

The Committee retained independent counsel to assist its investigation. After an exhaustive study, the Committee issued a report, which reflected the Committee's conclusions that the best interests of the Corporations would be served by a prompt dismissal of the suit as to a designated twenty-three of the thirty defendants. The Committee also recommended that a settlement be sought with the seven remaining defendants. After plaintiff refused to withdraw the action as to the twenty-three defendants, the Committee caused the Corporations to file a motion for summary judgment as to those defendants, based upon the Committee's independent and fully-informed business judgment.

The District Court, applying the rule in *Burks v. Lasker*, *supra*, concluded that, under Connecticut law, a committee of independent directors had the power to discontinue a derivative suit, subject to judicial review of the committee's good faith, motivation and thoroughness. 519 F. Supp. at 1318 (App. B-8). In reaching this conclusion, the District Court relied primarily upon the "extensive weight of judicial authority in other jurisdictions," because neither the

Connecticut courts nor the Connecticut legislature had addressed the specific issue presented. *Id.* After finding that the Committee exercised its business judgment thoroughly, independently and in good faith, the District Court granted summary judgment and dismissed the suit against the twenty-three designated defendants.

Acting by a divided panel, the Court of Appeals for the Second Circuit reversed on the basis of its conclusion that non-defendant directors can never be truly disinterested in suits involving their fellow directors. In doing so, the Second Circuit concluded that the Connecticut statutory and case law cited by the parties was not dispositive, 692 F.2d at 885 (App. A-9), and thus fashioned a rule of corporate law which requires the federal courts to determine *de novo* whether the maintenance of a derivative suit is in the best interests of the corporation. The Second Circuit then devised a complex mathematical analysis intended to define the judicial exercise of independent business judgment. *See* 692 F.2d at 891-93 (App. A-23 to A-26), and *compare* the dissent, 692 F.2d at 898 (App. A-37). Finally, instead of remanding the case to the District Court to allow the parties to develop a record applying the new standard, the Second Circuit proceeded to exercise its own business judgment, rejecting the conclusions of the special litigation committee and reversing the order for summary judgment.

The Corporations filed a timely petition for rehearing with suggestion for rehearing in banc. On December 21, 1982, the Court of Appeals denied the Corporations' petition. (App. C). Upon motion of petitioners, the Court of Appeals stayed the issuance of its mandate until January 24, 1983. The petitioners now respectfully file this petition for certiorari. In addition, it is expected that a petition for certiorari will be filed by certain individual defendants under the caption *Baldwin, et al. v. Joy.*

REASONS FOR GRANTING THE PETITION

Introduction

This case presents important questions concerning the proper role of the federal courts in relation to the governance of corporate affairs. The Second Circuit's opinion creates an issue as to whose business judgment shall determine whether derivative litigation is in the best interests of the corporation and then imposes upon th. courts the task of making that business judgment.

The rule now established by the Second Circuit requires the federal court to substitute its business judgment for that of independent, disinterested directors by conducting a trial *de novo* to determine whether the continuation of derivative litigation is in the corporation's best interests. The dissent effectively summarized that rule as being "so complicated, indefinite and subject to judicial caprice as to be unworkable." 692 F.2d at 898 (App. A-37). In formulating its novel rule, the Second Circuit departed from the accepted and usual course of judicial proceedings by failing to follow the instruction of this Court, by failing to consider the contrary decisions of three other courts of appeals and by failing to accord any weight to the District Court's analysis. Furthermore, the Court of Appeals deprived petitioners of due process of law by deciding issues of fact which first became material on appeal, without permitting petitioners to present evidence on such new issues in the trial court.

If allowed to stand, the Second Circuit's decision would require the courts to render business judgments which they are ill-equipped to make, and would burden the courts with an additional layer of complexity in administering the already complex process associated with derivative suits. Since most significant derivative litigation has arisen in the federal system, this Court should exercise its supervisory powers to eliminate this precedent for judicial interference in corporate affairs.

I. This Court Should Grant the Petition to Restrict Federal Court Interference with the Bona Fide Business Judgment of Corporate Directors.

A. The Second Circuit's Decision Is Contrary to the Instruction of *Burks v. Lasker*.

The business judgment rule is a fundamental principle of corporate law which entrusts the business decisions of a corporation to its board of directors. *See Burks v. Lasker*, *supra*, 441 U.S. at 487 (Stewart, J., concurring). This Court has long recognized the applicability of this rule to decisions concerning shareholder's derivative litigation:

> Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders.

United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917).

This Court reaffirmed the *United Copper* premise in *Burks v. Lasker*, 441 U.S. 471 (1979), in the specific context of disinterested directors effectively exercising their business judgment to discontinue a derivative suit brought against other directors. There, this Court held that disinterested directors could so exercise their business judgment provided that (i) the law of the corporation's state of incorporation permitted such action and (ii) such action was not inconsistent with federal policy. 441 U.S. at 486.

The *Burks* decision attempted to correct the erroneous view of the Second Circuit. That view held that, as a matter of law, disinterested directors were incapable of fairly deciding whether the continuation of derivative suits against other directors was consistent with the best interests of the corporation. *Lasker v. Burks*, 567 F.2d 1208, 1212 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979). This Court repudiated that premise, stating that "[w]hile lack of

impartiality may or may not be true as a matter of fact in individual cases, it is not a conclusion of law. . . ." *Burks v. Lasker, supra*, 441 U.S. at 485 n.15 (1979). The Second Circuit has now misapplied *Burks* to yield the same result as its repudiated *Lasker* premise. Indeed, the Second Circuit restated its *Lasker* rationale here:

> As a practical matter, new board members are selected by incumbents. The reality is, therefore, that special litigation committees created to evaluate the merits of certain litigation are appointed by the defendants to that litigation. It is not cynical to expect that such committees will tend to view derivative actions against the other directors with skepticism.

692 F.2d at 888 (App. A-16). As noted by the dissent, the Second Circuit "has been down this path before," only to be corrected by this Court. 692 F.2d at 900 (App. A-41). Again, correction is warranted.

Having been directly blocked by *Burks* from asserting its theory on a federal premise, the Second Circuit did so by purporting to interpret state law. Under the guise of following the first *Burks* criterion, the Second Circuit simply pronounced that Connecticut would not apply the traditional business judgment rule when independent directors recommended dismissal of a derivative suit. Instead of following the decided weight of authority (see *infra* at 10-11) and the thorough opinion of the District Court, the Second Circuit fashioned a novel rule which requires the reviewing court to determine independently whether continued litigation is in the corporation's best interests. Moreover, the methodology designed by the Court of Appeals to implement that rule constrains business judgment to a complex mathematical analysis with various levels of refinement. *See* 692 F.2d at 891-93 (App. A-23 to A-26). That methodology creates a "veritable Pandora's box of unanswered questions [which] raises more problems than it solves." 692 F.2d at 898 (App. A-37) (dissenting opinion).

The Court of Appeals' complex formula is not derived from any basis in Connecticut's corporate law.[1] Rather, it is evident that the stated "prediction" of Connecticut law is nothing more than the Second Circuit's federal policy repudiated in *Burks*, now dressed up as state policy. Surely, this Court's instruction cannot be so easily avoided.

B. The Second Circuit's Decision Conflicts with the Decisions of Other Courts of Appeals and Demonstrates the Need to Revisit the Rule of *Burks v. Lasker*.

The *Burks* decision states as the first element of its two-fold test that the authority of independent directors to act to discontinue derivative litigation is governed by state law. The courts of appeals which have considered this criterion have attempted to locate state law specifically acknowledging the authority of independent directors to discontinue a derivative suit. With the exception of the decisions of the New York, Delaware and Alabama state courts, however, there is an absence of such definitive authority in every state, including Connecticut. This circumstance requires the federal courts to look to the prevailing authority in other jurisdictions and to articulate the rule which appears best to effectuate the policy that directors manage corporate affairs in accordance with the prediction that the state would follow that rule. *See Hensley v. E. R. Carpenter Co.*,

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1. The Court of Appeals did cite to a Connecticut statute relating to officer and director indemnification, Conn. Gen. Stat. Ann. § 33-320a(b) (West 1982), as justification for its theory. However, the Court of Appeals acknowledged that the "provision has no direct application to this case," and that the provision merely suggested that the Connecticut law "does not bespeak a negative attitude toward enforcement of fiduciary obligations through meritorious derivative litigation." 692 F.2d at 889 (App. A-19). Thus, the statute is hardly evidence that Connecticut would adopt the Court of Appeals' unusual rule. The Court of Appeals noted other statutes referenced by the plaintiff, Conn. Gen. Stat. Ann. §§ 52-572j and 33-323 (West 1982), but did not rely on them as a basis for its decision. 692 F.2d at 890 (App. A-21).

Inc., 633 F.2d 1106, 1109 (5th Cir. 1980); *Bowen v. United States*, 570 F.2d 1311, 1322 (7th Cir. 1978). Indeed, that is the very process followed by the District Court.[2] 519 F. Supp. at 1318 (App. B-8). The responsibility of the federal courts to articulate the appropriate rule is underscored by the recognition that it is the federal courts and not the state courts which have been consistently called upon to make this determination.[3]

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2. The Second Circuit totally ignored the District Court's interpretation of Connecticut law. In doing so, the Second Circuit departed from the accepted rule that a district court's interpretation of the law of the state in which it sits is to be accorded substantial weight and should not be reversed unless it is clearly wrong. *E.g., Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198, 204-05 (1956); *Gaines v. Haughton*, 645 F.2d 761, 770 (9th Cir. 1981), *cert. denied*, 102 S. Ct. 1006 (1982); *Lomartira v. American Automobile Insurance Co.*, 371 F.2d 550, 554 (2d Cir. 1967).

3. The vast majority of decisions considering the application of the business judgment rule here at issue has been decided by the federal courts. *See, e.g., Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 102 S. Ct. 1006 (1982); *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Hasan v. CleveTrust Realty Investors*, 548 F. Supp. 1146 (N.D. Ohio 1982); *Mills v. Esmark, Inc.*, 544 F. Supp. 1275 (N.D. Ill. 1982); *Stein v. Bailey*, 531 F. Supp. 684 (S.D.N.Y. 1982); *Grossman v. Johnson*, 89 F.R.D. 656 (D. Mass. 1981), *aff'd on other grounds*, 674 F.2d 115 (1st Cir. 1982); *Watts v. Des Moines Register and Tribune*, 525 F. Supp. 1311 (S.D. Iowa 1981); *Genzer v. Cunningham*, 498 F. Supp. 682 (E.D. Mich. 1980); *Abella v. Universal Leaf Tobacco Co.*, 495 F. Supp. 713 (1980), *modified*, 546 F. Supp. 795 (E.D. Va. 1982); *Rosengarten v. International Tel. & Tel. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979); *Siegal v. Merrick*, 84 F.R.D. 106 (S.D.N.Y. 1979); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976). *Compare Roberts v. Alabama Power Co.*, 404 So.2d 269 (Ala. 1981); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. Sup. Ct. 1981); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

In accordance with the teachings of *Burks* and *United Copper*, the best rule, under these circumstances, is the one which acknowledges the authority of the directors and minimizes the role of the courts, particularly the federal courts, in exercising business judgment. Such a rule has been clearly articulated by the New York Court of Appeals:

> As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such claims lies *within the judgment and control of the corporation's board of directors.* Necessarily such decision must be predicated on the weighing and balancing of a variety of disparate considerations to reach a considered conclusion as to what course of action or inaction is best calculated to protect and advance the interests of the corporation. This is the essence of the responsibility and role of the board of directors, and *courts may not intrude to interfere.*

Auerbach v. Bennett, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1000-01, 419 N.Y.S.2d 920, 927 (1979) (emphasis added); *accord, Roberts v. Alabama Power Co.*, 404 So.2d 629 (Ala. 1981). The dissent here put it simply: "[w]hether to pursue litigation is not a judicial decision, rather it is a business choice." 692 F.2d at 898 (App. A-38).

The Second Circuit rejected *Auerbach* and instead devised an expanded version of the rule of *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. Sup. Ct. 1981). Through the *Zapata Corp.* rule, the Delaware Supreme Court has imposed on its trial courts the burden of second-guessing the business judgment of independent directors. The Second Circuit itself conceded that "[i]ndependent judicial scrutiny of a special litigation committee's recommendation is apt to be difficult. . . ." 692 F.2d at 891 (App. A-23). Nevertheless, the Second Circuit has now imposed that burden on the federal courts.

In assuming the responsibility for exercising a "judicial business judgment," the Second Circuit has parted company with the other three courts of appeal which have con-

fronted the issue. In considering motions by independent directors to terminate derivative suits, the Ninth, Eighth and Fifth Circuits have deemed the scope of judicial inquiry to be limited to the independence, good faith and thoroughness of those directors exercising the business judgment. None of those decisions was distinguished or even cited by the Second Circuit.

Each of the other courts of appeals in applying *Burks* in the absence of definitive state authority has endorsed *Auerbach* as the proper rule. The Ninth Circuit, in *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 102 S. Ct. 1006 (1982) (construing California law), upheld the action of independent directors, reasoning that:

> The role of a court in this situation is limited to determining the disinterested independence of the committee members and the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee.

645 F.2d at 771. *See also Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980). The Eighth Circuit reached the same result. *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980) (construing the then undetermined Delaware law). Finally, the Fifth Circuit adopted the *Auerbach* rule and, upon finding a lack of independence of the acting directors, ultimately declined to uphold the dismissal of the derivative suit. *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49, 52 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981) (construing Texas law).

This Court can remedy the present division among the courts of appeals and can avoid an expansion of that division by specifying the applicable rule in the circumstances where there is an absence of definitive state law. Consistent with existing authority, that rule must recognize both the role of the independent directors in exercising business judgment and the role of the federal courts in exercising

judicial judgment limited to a review of the bona fides of the directors' action.

Additionally, this case provides an appropriate occasion for the Court to revisit *Burks* and to define expressly the requisite analysis to be undertaken in ascertaining the state law criterion. As noted above, only three states have considered the authority of independent directors to discontinue derivative litigation, and therefore federal courts have been asked repeatedly to speculate as to state law without the benefit of controlling state authority. The concurring opinion of Justice Stewart in *Burks* suggests that the appropriate inquiry should focus simply on whether state law authorizes the board of directors to govern corporate affairs and to delegate authority to independent directors. *See Burks v. Lasker, supra*, 441 U.S. at 487 (1979) (Stewart, J., concurring).[4] That approach would dramatically simplify the *Burks* test. Such a direct inquiry would minimize the likelihood of future conflicts among the courts of appeals on this question. Consistent with the traditional business judgment rule, such a direct inquiry would have the additional advantage of minimizing judicial interference in the corporate decision-making process.

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4. The District Court expressly determined that this traditional authority existed in Connecticut *(see* Conn. Gen. Stat. Ann. §§ 33-313 (a) and 33-318 (a)), but then concluded that *Burks* required the more specific analysis of the directors' power in discontinuing derivative suits. 519 F.Supp. at 1318 (App. B-8). The Second Circuit ignored the existence of this traditional authority. *See, e.g.*, MODEL BUSINESS CORPORATION ACT §§ 35 and 42 (1977 Supp.)

II. This Court Should Grant the Petition Because the Second Circuit Deprived Petitioners of Due Process of Law.

The Second Circuit held that a derivative action could only be dismissed if the action were not in the corporation's best interests, as measured by the court's independent business judgment. The Second Circuit also promulgated detailed standards regarding the exercise of judicial business judgment. The Court of Appeals then applied its new rule without granting petitioners the opportunity to present evidence in support of the Committee's decision that the suit was not in the best interests of the Corporations. See 692 F.2d at 894-97 (App. A-29 to A-35).

The trial court expressly declined to evaluate whether the suit served the Corporations' best interests, stating that it "has maintained this position throughout, by limiting plaintiff on three occasions to discovery as to the good faith motivation and thoroughness of the Committee's investigation." 519 F. Supp. at 1325 n.6 (App. B-24). Not surprisingly, petitioners did not at any time offer any evidence as to the correctness of the Committee's business judgment because the merits of that judgment were never before the District Court. Petitioners certainly did not address the detailed guidelines subsequently established by the Court of Appeals, since they had no reason to contemplate such guidelines. Accordingly, the Court of Appeals departed from the accepted and usual course of judicial proceedings by failing to base its decision on the merits on "an adequate and full-bodied record." *Public Affairs Associates, Inc. v. Rickover*, 369 U.S. 111, 113 (1962).

More significantly, the Second Circuit's decision on the merits deprived the petitioners of due process of law. In *Saunders v. Shaw*, 244 U.S. 317 (1917), this Court, through Mr. Justice Holmes, held that it is a violation of the due process provision of the Constitution to decide a case against a person "without his ever having had the proper

opportunity to present his evidence." 244 U.S. at 319. *Compare Hamling v. United States*, 418 U.S. 87, 110 n.11 (1974); *Helis v. Ward*, 308 U.S. 365 (1940). That is precisely the dilemma presented here. Petitioners have never been allowed the opportunity to present evidence that the discontinuance of this suit to the extent recommended by the Committee is in the Corporations' best interests.

In their petition for rehearing, petitioners requested that the Court of Appeals provide them with an opportunity to present facts critical to the issue first framed by that court. See Petition of Defendant-Appellees Citytrust and Citytrust Bancorp, Inc. for Rehearing with Suggestion for Rehearing In Banc at 7-8. Petitioners did not raise this issue earlier, since they could not possibly have anticipated that the Second Circuit would not only establish, but apply a new rule of law. In these circumstances a writ of certiorari on this issue is proper. *Saunders v. Shaw*, *supra*, 244 U.S. at 320.

In declining to grant rehearing, the Court of Appeals refused petitioners' request for a new evidentiary hearing. By deciding on appeal that the Committee's business judgment was erroneous, without permitting petitioners to present any evidence on the issue, the Court of Appeals deprived petitioners of due process of law in violation of the Fifth Amendment. Unless this Court grants certiorari to require a new trial on the issue unexpectedly injected into the case by the Court of Appeals, petitioners will be left with no remedy for this violation of their constitutional rights. Indeed, under the circumstances presented here, summary reversal on this issue is appropriate.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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